121 FERC ¶ 61,002
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

Northern Natural Gas Company Docket No. AC07-129-001

ORDER ON REHEARING

(Issued October 1, 2007)

1. On July 17, 2007, Northern Natural Gas Company (Northern) filed a request for rehearing of a delegated letter order issued June 18, 2007, by the Chief Accountant (June 18 Order).[1] The June 18 Order addressed Northern's May 1, 2007 request for guidance regarding the accounting treatment for leak clamps installed to repair leaks on a 20-inch diameter section of the Matagorda Offshore Pipeline System (20-inch lateral). Northern contended that, given the timing and the costs of the repairs, all of the costs for the four repairs should be treated as abandonment costs.

2. In the June 18 Order, the Chief Accountant determined that, under the provisions of the Uniform System of Accounts (USofA), the costs of the first three leak clamps (also known as pipeline sleeves) are properly classified as maintenance expense, while the cost of the subsequent installation of the fourth leak clamp to repair an additional leak is properly classified as an abandonment cost (cost of removal). The June 18 Order directed Northern to revise its accounting procedure to ensure that it accounts for future installations of leak clamps consistent with the requirements of the USofA and to record a correcting journal entry to expense the cost of installing the first three leak clamps.

3. On rehearing, Northern contends that the Commission should allow the costs of installing all of the leak clamps to be capitalized in the gas plant accounts as the installation of minor items of property that result in a substantial addition. Northern points out that the description for Account 367, Mains, specifically includes "leak

[1] *Northern Natural Gas Company*, Docket No. AC07-129-000 (June 18, 2007) (unpublished letter order).

clamps." In the alternative, Northern argues that the Commission should allow it to define leak clamps as a retirement unit in Northern's property unit catalog and to capitalize all of the leak clamps. The Commission denies rehearing, but will grant Northern's alternative request to update its property unit catalog. As discussed below, Northern may capitalize leak clamps or split sleeves on a prospective basis if the nature of the work meets the criteria for capitalization.

Background

4. In its request for accounting guidance, Northern stated that it discovered the first two pipeline leaks in the 20-inch lateral on March 1, 2006. Northern explained that it isolated the leaks and installed the leak clamps to remedy the pin-hole leaks. According to Northern, while the leak clamps were being installed, Northern discovered a third leak in the same proximity, isolated it, and installed another leak clamp. The installation of the three leak clamps was completed on July 6, 2006, and the line was returned to service on the same day. On July 20, 2006, within two weeks of returning the line to service, Northern confirmed a fourth leak on the 20-inch lateral. Northern stated that it declared a *force majeure* on July 20, 2006, effective July 21, 2006, and decided that the pipeline should be abandoned. Northern explains that it completed installation of the fourth leak clamp in August 2006; however, consistent with its abandonment decision, it did not return the 20-inch lateral to service.

5. Northern stated that it capitalized the costs of installing the first three leak clamps to Account 332, Field Lines, as minor items of property in accordance with Gas Plant Instruction (GPI) 10C(1). Northern stated that the total cost of installing the first three leak clamps was $5.7 million, and the cost of installing the fourth leak clamp was $1.2 million. Northern argued that the timing of its discovery of the leaks and the repairs supports classification of the costs of all four repairs as abandonment costs.

6. The June 18 Order cited GPI 10C(1), which states in part as follows: "When a minor item of property which did not previously exist is added to plant, the cost thereof shall be accounted for in the same manner as for the addition of a retirement unit . . . if a substantial addition results. . . ."[2] The June 18 Order acknowledged that Northern considered the cost of installing the leak clamps to be substantial.

7. The June 18 Order noted that Northern repaired the first three leaks and returned the 20-inch lateral to service on July 6, 2006. However, the June 18 Order emphasized that Northern discovered the fourth leak on July 20, 2006, completed that repair in August 2006, and at that point, decided to abandon the 20-inch lateral. The June 18 Order also stated that Northern capitalized the costs to install the first three leak clamps as minor items of property in Account 332, Field Lines, in accordance with GPI 10C(1),

[2] 18 C.F.R. Part 201, Gas Plant Instructions No. 10C(1) (2007).

while it charged the costs of the fourth leak clamp to Account 108, Accumulated Provision for Depreciation of Gas Utility Plant. The June 18 Order noted that Northern cited the USofA, which defines cost of removal as "the cost of demolishing, dismantling, tearing down or otherwise removing gas plant, including the cost of transportation and handling incidental thereto"[3] and that Northern contended that the cost to install the fourth leak clamp and prospective additional costs to either abandon the 20-inch lateral in place or to remove part or all of that lateral constitute costs of removal.

8. According to the June 18 Order, in support of its treatment of the costs, Northern pointed out that (1) the leaks occurred within a limited period during the pipeline investigation; (2) Minerals Management Service regulations require the leaks to be repaired regardless of whether the pipeline is abandoned in place or partially or totally removed; (3) only minimal incremental costs were incurred to return the pipeline to service; and (4) the pipeline was in service for only two weeks before the fourth leak was confirmed and Northern made the decision not to return the 20-inch lateral to service based on the location and timing of the leaks.

9. The June 18 Order disagreed with Northern's accounting treatment, stating that, under the USofA, the cost of maintenance chargeable to the various operating expense and clearing accounts includes "labor, materials, overheads and other expenses incurred in maintenance work."[4] The June 18 Order further explained that the USofA includes as maintenance work "work performed specifically for the purpose of preventing failure, restoring serviceability, or maintaining the life of the plant."[5] On that basis, the June 18 Order stated that the work of installing the first three leak clamps is consistent with this description of maintenance work.

10. The June 18 Order pointed out that the work operations listed in the USofA as maintenance relate to types of work rather than focusing on the level of the costs involved. In addition, continued the June 18 Order, even if the first three leak clamps are minor items that did not previously exist, that does not change the fact that the purpose of those three leak clamps was to restore serviceability and maintain the life of the lateral, which is a maintenance activity. The June 18 Order also emphasized that, after it installed the first three leak clamps, Northern placed the line back in operation. In the June 18 Order, the Chief Accountant stated that the fact that Northern discovered the fourth leak two weeks after it placed the 20-inch lateral back in service and then decided to abandon the line does not change the nature or character of the costs of installing the first three leak clamps.

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[3] 18 C.F.R. Part 201, Definitions No. 10 (2007).

[4] 18 C.F.R. Part 201, Operating Expense Instruction No. 2A (2007).

[5] 18 C.F.R. Part 201, Operating Expense Instruction No. 2, Items (2007).

11. The June 18 Order also determined that the costs of installing the first three leak clamps on the 20-inch lateral should have been charged to Account 764, Maintenance of Field Lines. Accordingly, the June 18 Order directed Northern to revise its accounting for these three leak clamps by crediting the appropriate gas plant account and debiting Account 764 for $5.7 million. Finally, the June 18 Order stated that the $1.2 million cost of installing the fourth leak clamp and any additional costs incurred to abandon the 20-inch lateral in place or to remove part or all of the line constitute costs of removal under the USofA as costs incurred to prepare property for abandonment, which must be charged to Account 108 as costs of removal.[6]

Request for Rehearing

12. On rehearing, Northern argues that the Commission should allow the costs of the installation of all four leak clamps to be capitalized as the installation of minor property items that create a substantial addition, as contemplated by GPI 10C. Northern asserts that the Commission's failure to follow GPI 10C or to provide a reasoned explanation for disregarding that instruction was arbitrary and not reasoned decision-making. In the alternative, Northern contends that the Commission should authorize it to classify the leak clamps as a retirement unit in Northern's property unit catalog and to capitalize such installations in accordance with the requirements of GPI 10B.

13. Northern maintains that it properly supported its basis for capitalizing the costs of the first three leak clamps. Citing GPI 10C(1), Northern argues that, when a minor item of property is added that did not exist previously, the cost is treated in the same manner as the addition of a retirement unit if it results in a substantial addition. Northern emphasizes that these three leak clamps were new and were not installed to replace previous leak clamps. Northern reiterates that, in the USofA, the Account 367, Mains, description specifically includes "leak clamps" as Item No. 10 and also refers to GPI 10C(1), which contains the "substantial addition" provision.[7] Because the cost of each leak clamp exceeded $1 million, Northern submits that they resulted in a substantial addition. However, Northern asserts that the Commission's analysis is incomplete and not dispositive of Northern's situation because the issue is not whether the repairs constituted maintenance, but rather whether the costs could be capitalized.

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[6] 18 C.F.R. Part 201; Account 108B, Accumulated provision for depreciation of gas utility plant (2007).

[7] Northern states that it capitalized the cost of the leak clamp installations to Account 332, Field Lines, due to the functional classification of such lines as gathering; however, such leak clamps are just as likely to be installed on gathering lines as they would be on transmission lines (Account 367, Mains).

14. Northern argues that the June 18 Order did not address or explain why, when the account description for Account 367, Mains, specifically includes leak clamps in its items list, such leak clamps may not be capitalized. Because leak clamps are installed only to prevent or repair leaks, Northern claims that the USofA intends the installation costs of such clamps to be capitalized to the pipe segments on which they are installed.

15. Northern further submits that the Commission also ignored the cost of the leak clamps in determining that the work could not be capitalized. Northern states that the Commission relied exclusively on 18 C.F.R. Part 201, Operating Expense Instruction No. 2C (OEI 2C), Item 3, and found that "the purpose of the [leak clamps] was to restore serviceability and maintain the life of the lateral, a maintenance activity." However, continues Northern, Item 3 must be read in conjunction with Item 8, which states, "Replacing or adding minor items of plant which do not constitute a retirement unit. (See Gas Plant Instruction 10.)" Northern points out that OEI 2C, Item 8, acknowledges the relevance of cost by distinguishing "minor items" from a "retirement unit." Further, continues Northern, GPI 10C also takes cost into consideration by referring to "a substantial addition." Thus, Northern reasons that OEI 2C, Item 8, and GPI 10 make it clear that cost is a principal factor in determining whether Northern's expenditure for leak clamps should be capitalized or expensed as maintenance.

16. For the first time, Northern proposes on rehearing an alternative approach. Northern argues that the Commission should grant rehearing and authorize it to define the leak clamps as a retirement unit in its property unit catalog and to capitalize them under the requirements of GPI 10B. According to Northern, if it had replaced the pipe, the cost would have been capitalized. Because the leak clamps were intended to serve the same purpose as new pipe, Northern reasons that they should receive the same accounting treatment. Northern submits that the Commission should not deter pipelines from seeking lower cost operational solutions by imposing expense treatment on such solutions when capitalization of such costs is consistent with the USofA. Further, states Northern, the definition of "retirement units" in 18 C.F.R. § 201.34 includes "items of gas plant which, when retired, with or without replacement, are accounted for by crediting the book cost thereof to the gas plant account in which included." In Northern's view, both the definition of retirement units and GPI 10B are broad enough to include leak clamps. Northern states that expense treatment pursuant to the Operating Expense Instructions is the appropriate treatment only if the costs incurred do not qualify for capitalization under the Gas Plant Instructions.

Commission Analysis

17. The Commission denies rehearing of the June 18 Order. Northern has not shown that the Chief Accountant incorrectly analyzed the facts or reached unsupported conclusions.

18. Northern's own submissions in this proceeding make it clear that the first three leak clamps were installed at the same time and for the purpose of allowing the 20-inch lateral to be returned to service, which in fact did occur. Just two weeks after repairing the first three leaks and returning the pipe to service, Northern discovered the fourth leak and repaired it in August. The discovery of this fourth leak precipitated Northern's decision to abandon the 20-inch lateral and not return it to service. The Commission finds that Northern's clear intent and its actions in making the first three repairs and returning the line to service versus its intent and actions in making the fourth repair mandate different accounting treatment for the first three repairs and the fourth repair. Based on the facts presented by Northern, the June 18 Order correctly directed Northern to account for the repairs.

19. The Commission also is not persuaded by Northern's assertion that leak clamps should be capitalized in Account 332 because leak clamps are among the items listed in Account 367. While it is true that Account 367 lists leak clamps as an item includible in Account 367, the costs of installing leak clamps are only allowable in Account 367 in certain circumstances. This is the reason why, when leak clamps are listed under the items includible in Account 367, the instruction refers back to GPI 10. GPI 10 involves the use of an accounting convention that relies on the designation of gas plant as retirement units or minor items for purposes of determining whether costs related to additions of property are to be charged to expense or capitalized.[8] This same accounting convention applies whether the item relates to Account 367 or Account 332.

20. As stated above, Northern treats leak clamps as a minor item of property. Under the provisions of GPI 10, a minor item of property which did not exist previously can only be capitalized if a substantial addition results. Otherwise such amounts must be charged to maintenance expense. A substantial addition results when the minor item being added extends the useful life, operating capacity or efficiency of the retirement unit it is added to, in this case the 20-inch lateral.[9] An expenditure which returns property to the state it was in before the situation prompting the expenditure arose and which does not make the relevant property more useful or longer-lived is maintenance expense under GPI 10.

21. The useful life of the 20-inch lateral was not intended to be prolonged by the leak clamps beyond the useful life originally contemplated. It was rather a repair intended to keep the system functioning in a safe and efficient manner. The repair also was not

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[8] 18 C.F.R Part 201 (2007).

[9] *Southern California Edison Co.*, 40 FERC ¶ 61,124, at p. 61,370 (1987) (*SoCal Edison*).

intended to increase the capacity or efficiency of the 20-inch lateral in comparison with its original leak-free condition. The installation of the leak clamps merely was intended to allow the 20-inch lateral to continue to perform the same function as before, namely, transporting gas.

22. The leak clamps used in the repair work in this instance obviously did not extend the useful life, operating capacity or efficiency of the 20-inch lateral, as the pipeline only remained in operation for about two weeks before being abandoned. Further, Northern's intent in installing the leak clamps was not to extend the useful life of the 20-inch lateral beyond that originally contemplated, nor to increase its operating capacity or efficiency. The purpose of the first three leak clamps was simply to return the 20-inch lateral to its prior operating state before the leaks. Consequently, the first three leak clamps do not qualify as a substantial addition under GPI 10, and their costs must be charged to maintenance expense.

23. Additionally, Northern is mistaken that cost is a principal factor in determining whether Northern's expenditures for leak clamps should be capitalized or expensed as maintenance under the Commission's accounting rules. While cost is one factor to consider in determining whether to capitalize or expense an item, it is the nature and purpose of the work performed which governs the classification of costs under the USofA.[10] The purpose of the work in this instance was to repair and restore the lateral to service and maintain its life, which is a maintenance activity under OEI 2C as stated in the June 18 Order.

24. Further, as the June 18 Order correctly points out, the fact that installing the leak clamps is an expensive maintenance procedure does not alter the fact that it is maintenance. For instance, in the *SoCal Edison* proceeding, the Commission found that $58 million of sleeving (pipe/tube modification) costs could not be capitalized as plant in service.[11] This sleeving project involved modifications to the steam generator tubes or pipes by inserting a sleeve or another pipe within the existing tube or pipe. The work did not meet the criteria for capitalization as a substantial addition by extending the useful life, operating capacity, or efficiency of the steam generator. Also, in that case, the work was performed specifically for the purpose of preventing failure, restoring serviceability, or maintaining the life of the plant. Moreover, even using cost as the determining factor as Northern proposes, the Commission does not believe that adding three leak clamps totaling $5.7 million would serve to qualify as a substantial addition on a system as large

[10] *Unison Transformer Service, Inc.*, 48 FERC ¶ 61,327, at p. 62,077 (1989).

[11] *Southern California Edison Co.*, 40 FERC ¶ 61,124, at p. 61,370 (1987). *See also El Paso Natural Gas Co.*, 82 FERC ¶ 61,006, at 61,022 n.20 (1998).

as Northern’s, which totaled $2.9 billion in total gas plant in-service as of December 31, 2006.

25. Northern also asserts that the Commission should not deter pipelines from seeking lower cost operational solutions, such as installing leak clamps, by imposing expense treatment on such a solution, because, if Northern had replaced the pipe itself, the cost would have been capitalized. However, as the Commission has stated in the past, its accounting rules are not construed on the basis of whether they will provide proper incentives or disincentives.[12] The purpose of these rules is to accurately, consistently, and neutrally portray the financial performance of regulated companies. According to those rules, Northern must charge maintenance expense with the cost of installing the first three leak clamps. If an exception were allowed to these rules whenever a party cited a possible incentive or disincentive, the rules would no longer serve their purpose of properly depicting financial performance. The appropriate forum for Northern's incentive arguments is a proceeding focused on ratemaking treatment, not accounting treatment.

26. Finally, in the alternative, Northern states that, if the Commission does not agree that pipelines should be allowed to capitalize leak clamps in accordance with the requirements of GPI 10C, Northern should be authorized to define pipe sleeves or leak clamps as a retirement unit in its property unit catalog and to capitalize such installations under the requirements of GPI 10B.

27. Northern can update its existing property unit catalog to include pipeline split-sleeves as a retirement unit on a prospective basis if it suits its business needs.[13] However, Northern must continue to assess whether the nature of any future work involving pipeline clamps involves a capital addition or maintenance project. In this particular instance, the nature of the work is maintenance expense.

28. For example, if the split-sleeves or pipeline clamps are part of the materials and supplies used during the construction of a new pipeline, Northern would capitalize the cost as a component of construction costs. Once capitalized as part of the cost of construction, Northern could capitalize the cost of replacement should it need to replace this component in the future. Additionally, Northern could capitalize the cost of pipeline clamps and split-sleeves when used to join pipe to extend the length of the existing pipe line. However, the cost of materials and supplies such as split-sleeves used to repair a pipeline that is in-service, as is the case here, would be charged to maintenance expense. Consequently, Northern can update its property unit catalog to include pipeline clamps or split sleeves meeting the requirement for capitalization as a retirement unit on a

[12] *Dow Corning Corp*., 59 FERC ¶ 61,191, at p. 61,666 (1992).

[13] *Units of Property Accounting Regulations*, Order No. 598, FERC Stats. & Regs. ¶ 31,061 (1998).

prospective basis. However, Northern may not capitalize the cost of the three leak clamps that are the subject of this order.

<u>The Commission orders</u>:

Rehearing of the June 18 Order is denied, as discussed in the body of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Acting Deputy Secretary.